

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**NATIONAL HERITAGE INSURANCE
COMPANY
CHICO, CALIFORNIA**

**AUDIT OF MEDICARE FINAL
ADMINISTRATIVE COST PROPOSALS
FOR THE PERIOD OCTOBER 1, 1995
THROUGH SEPTEMBER 30, 1998**



**JUNE GIBBS BROWN
Inspector General**

**APRIL 2000
CIN: A-09-99-00090**

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**NATIONAL HERITAGE INSURANCE
COMPANY
CHICO, CALIFORNIA**

**AUDIT OF MEDICARE FINAL
ADMINISTRATIVE COST PROPOSALS
FOR THE PERIOD OCTOBER 1, 1995
THROUGH SEPTEMBER 30, 1998**

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represents the findings and opinions of the HHS/OIG Office of Audit Services. Final determination on these matters will be made by authorized officials.



**JUNE GIBBS BROWN
Inspector General**

**APRIL 2000
CIN: A-09-99-00090**



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Region IX
Office of Audit Services
50 United Nations Plaza
San Francisco, CA 94102

CIN: A-09-99-00090
April 17, 2000

Skip Verser
Chief Financial Officer
National Heritage Insurance Company
402 Otterson Drive
Chico, CA 95928

Dear Mr. Verser:

This report provides you with the Audit of Medicare Administrative Costs claimed by National Heritage Insurance Company (NHIC) for the period October 1, 1995 through September 30, 1998. The audit was performed by Conrad and Associates, L.L.P. The review was completed under a contract with the Department of Health and Human Services, Office of Inspector General (OIG). The OIG exercised technical oversight and quality control of the examination. In our oversight, we found nothing to indicate that Conrad and Associates, L.L.P., Certified Public Accountants' work was inappropriate or that the report cannot be relied upon. The audit was conducted in accordance with the "Standards for Audit of Governmental Organizations, Programs, Activities and Functions," 1994 revision (GAO Standards).

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG Office of Audit Services' reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act, which the Department chooses to exercise. (See Section 5.71 of the Department's Public Information Regulation, dated August 1974, as revised.)

To facilitate identification, please refer to Common Identification Number A-09-99-00090 in all correspondence relating to this report.

Sincerely,

Lawrence Frelot
Regional Inspector General
for Audit Services

Enclosures

cc: Elizabeth C. Abbott

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

CONRAD AND ASSOCIATES, L.L.P.
1100 Main Street, Suite C
Irvine, California 92614

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Table of Contents

	<u>Page</u>
Executive Summary	1
Acronyms	3
Introduction and Background	4
Objectives and Scope of Audit	7
Auditors' Reports:	
Independent Auditors' Report on Medicare Final Administrative Cost Proposals	10
Report on Compliance and On Internal Control Over Financial Reporting Based on an Audit of Final Administrative Cost Proposals Performed in Accordance with <i>Government Auditing Standards</i>	11
Findings and Recommendations	13
Other Matters:	
Resolution of Prior Audit Findings	19
Interim Expenditure Reports	19
Data Processing Costs	19
Complementary Insurance Credits	19
Subsequent Event	19

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Table of Contents, (Continued)

	<u>Page</u>
Schedules:	
A. Final Administrative Cost Proposals by Cost Classification	21
B. Final Administrative Cost Proposal - Budget to Actual FYE 9/30/98	22
C. Final Administrative Cost Proposal - Budget to Actual FYE 9/30/97	23
D. Final Administrative Cost Proposal - Budget to Actual FYE 9/30/96	24
Appendices:	
Appendix A - Auditee's Response	

EXECUTIVE SUMMARY

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Executive Summary

Conrad and Associates, L.L.P., Certified Public Accountants, under contract with the U.S. Department of Health and Human Services (DHHS), performed a financial and compliance audit of expenditures claimed by National Heritage Insurance Company (NHIC) related to administration of the Medicare Part B program. The audit covered Final Administrative Cost Proposals (FACP's) for the Medicare program submitted by the NHIC for the period of October 1, 1995 through September 30, 1998.

Our audit included such tests necessary to assure that costs charged to Medicare were allowable and allocable and were provided in an economic and efficient manner. Our audit efforts tested the allowability of those administrative costs as well as their allocability to the Medicare program using the Medicare agreements, the Federal Acquisition Regulation (FAR), and appropriate cost accounting standards and generally accepted accounting standards as guiding criteria.

Results of Audit

For the period under audit, the NHIC reported Medicare Part B program administrative costs of \$87,734,514. We have not questioned any reported costs. However, the total costs reported included pension and Home Office indirect costs allocated to NHIC, which were excluded from the scope of our audit. See the Objectives and Scope of Audit section of this report for a total of costs excluded from our audit procedures.

We did, however, offer HCFA a recommendation regarding the method used by NHIC to allocate its share of indirect general and administration (G&A) costs as well as return on investment (ROI) costs allocated from Electronic Data Systems (EDS) Federal Corporation Health Care ("Home Office allocations"). See the Findings and Recommendations section of the accompanying report for a cost analysis based on this alternate allocation method.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Executive Summary, (Continued)

Auditee's Response

A draft copy of the report was provided to the NHIC. The responses where appropriate, has been included in the body of the report, and included in their entirety as Appendix A.

We believe that the NHIC has established effective systems of internal control, accounting, and reporting for administrative costs claimed for reimbursement under the Medicare program.

* * * * *

CONTRACT DISCLOSURE STATEMENT

This report is made pursuant to Contract HHS-100-95-0023 with Conrad and Associates, L.L.P., Certified Public Accountants, 1100 Main Street, Suite C, Irvine, California 92614. Certain information contained herein is subject to disclosure under the Freedom of Information Act, 5 U.S.C. 522(b)(4). The Task Monitor was Dave A. Dimler, Health Care Financing Administration, 7500 Security Boulevard, Baltimore, Maryland 21244.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Acronyms

NHIC	The National Heritage Insurance Company
DHHS	U.S. Department of Health and Human Services
FACP	Final Administrative Cost Proposal
FAR	Federal Acquisition Regulation
FY	Fiscal Year
HCFA	Health Care Financing Administration
OIG	Office of Inspector General, U.S. Department of Health and Human Services

INTRODUCTION AND BACKGROUND

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Introduction and Background

Health Insurance for the Aged and Disabled (Medicare), Title XVIII of the Social Security Act, provides for a hospital insurance program (Part A) and a related supplementary medical insurance program (Part B) for: (i) eligible persons aged 65 and over; (ii) disabled persons under age 65 who have been entitled to Social Security or Railroad Retirement disability benefits for at least 24 consecutive months; and (iii) individuals under age 65 with chronic kidney disease who are currently insured by, or entitled to, Social Security benefits. Medicare Part A provides protection against the costs of hospital inpatient care, post-hospital extended care, and post-hospital home health care, while Medicare Part B is a voluntary program providing protection from the cost of physician services, hospital outpatient services, home health care services, and other health services.

The Health Care Financing Administration (HCFA), within the U.S. Department of Health and Human Services (DHHS), administers the Medicare program. Title XVIII provides, however, that public or private organizations (known as "intermediaries" for Medicare Part A and "carriers" for Medicare Part B) may assist in the program's administration.

Intermediaries are organizations, primarily Blue Cross plans and commercial insurance companies that have been nominated by provider groups or associations to process bills and make payments that are due under the Medicare program.

Carriers are organizations, primarily Blue Shield plans and commercial insurance companies that have been selected by the Secretary, DHHS, to handle all medical claims for a designated area. Contracts are executed between the Secretary and the Blue Shield plans and commercial insurance companies that participate as Medicare carriers.

The agreements (or contracts) define the functions to be performed and provide for the reimbursement of allowable administrative costs incurred in their performance. Each participating intermediary and carrier (contractor) submits a prospective budget of administrative costs to be incurred during the Government fiscal year to the HCFA Regional Office for review and approval. The contractors reporting accrued expenditures also submit monthly expenditure reports. Following the close of each fiscal year, a final administrative cost proposal (FACP) is submitted, reporting the costs of performing Medicare functions incurred during the year. This cost proposal and supporting data serve as the basis for final settlement of allowable administrative costs.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Introduction and Background. (Continued)

Copies of each contractor's FACP are furnished by the HCFA Regional Offices to the appropriate Regional Office of Inspector General (OIG). After audit of the cost proposals, the contractor and HCFA negotiate a final settlement.

Contracts have been executed between HCFA and the NHIC to perform services in various states as a carrier under Part A of the Medicare program. NHIC was required to receive, disburse, and account for funds in making payments for services furnished to eligible individuals. Other functions included making determinations as to coverage of services and reasonableness of charges, furnishing timely information and reports to HCFA, and maintaining records to ensure the correctness and verification necessary for the administration of the contracts. Detailed requirements were specified in the HCFA Manual, which NHIC was required to follow.

NHIC was paid its costs for administration of the contracts under the principle of neither profit nor loss. Appendix B of the contracts and referenced federal regulations identified allowable administrative costs that could be reimbursed. Included in the administrative costs claimed for reimbursement are costs for general and administrative expenses attributable to the general management, supervision, and conduct of a contractor's business as a whole. HCFA and NHIC negotiated the amount of an annual budget for administrative expenses.

NHIC accumulates administrative costs incurred under the Medicare program as either direct costs or indirect costs.

The Medicare Agreement states "...costs allowable and allocable under this agreement shall be determined in accordance with the provisions of Part 31 of the Federal Acquisition Regulation (FAR), as interpreted and modified by Appendix B of the agreement."

Section 31.201 of the FAR defines the total cost of a contract as the sum of the allowable direct and indirect costs allocable to a contract, incurred or to be incurred, less any applicable credits. The regulations also state that items of cost are allowable charges if they meet tests of reasonableness and allocability and if generally accepted accounting principles are followed.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Introduction and Background. (Continued)

A reasonable cost is defined as one that would be incurred by an ordinary prudent person in the conduct of a competitive business. Further, a cost is allocable if it is assignable or chargeable to a particular cost objective in reasonable proportion to the benefits received.

FAR Sections 31.202 and 31.203 define direct and indirect costs as follows:

- Direct Costs: Any cost that can be identified specifically with a particular final cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly.
- Indirect Costs: Any cost that, because of its incurrence for common or joint objectives, is not readily subject to treatment as a direct cost.

This report details the results of our audit of the FACP's submitted by NHIC to HCFA for the period October 1, 1995 through September 30, 1998.

OBJECTIVES AND SCOPE OF AUDIT

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Objectives and Scope of Audit

Our audit of the FACP's submitted by NHIC for the fiscal years (FYs) ended September 30, 1996, 1997 and 1998, was made in accordance with generally accepted auditing standards and the standards for financial audits contained in the *Government Auditing Standards* as revised in 1994 and issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the FACP's are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the FACP's. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the FACP's. We believe that our audit provides a reasonable basis for our opinion.

The U.S. Department of Health and Human Services' (DHHS) Audit Guide for the Review of Administrative Costs Incurred by Medicare Intermediaries and Carriers under Title XVIII of the Social Security Act (February 1991 revision) and other appropriate guidelines and instructions were used as guides in the audit.

The audit was performed to provide HCFA with sufficient data to close out the FACP's and determine if controls were adequate for administration of the Medicare program.

An entrance conference was held on June 1, 1999 with NHIC in Chico, California. Fieldwork was performed during the period of June 1, 1999 through June 24, 1999. Our audit was conducted at NHIC's office in Chico, California. A preliminary exit conference was held with NHIC and HCFA representatives in Chico, California on June 24, 1999 to discuss tentative findings and request that additional information from the home office of NHIC be sent to our office to complete our audit procedures. A final exit conference was conducted telephonically with HHS-OIG and NHIC representatives on February 14, 2000.

Administrative costs claimed for each of the periods under audit were as follows:

Fiscal year ended September 30, 1996	\$ 1,177,691
Fiscal year ended September 30, 1997	29,322,135
Fiscal year ended September 30, 1998	<u>57,234,688</u>
Total	\$ <u>87,734,514</u>

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Objectives and Scope of Audit. (Continued)

The specific objectives of our audit were to:

1. Determine whether NHIC had established an effective system of internal control, accounting, and reporting for administrative costs incurred under the program.
2. Ascertain whether the FACP's present fairly the cost of program administration allowable in accordance with FAR, Title 48, Chapter 1, Part 31 as interpreted and modified by the Medicare agreements.
3. Ascertain whether NHIC has complied with contractual and administrative requirements governing specific items of cost.
4. Identify the underlying causes of significant errors or problems noted and make recommendations for improvement or adjustment of costs claimed as appropriate.

Pension and Home Office indirect cost allocations for general and administrative (G&A) costs as well as return of investment costs (ROI) claimed by NHIC and included in the FACP's were excluded from the scope of our audit. The U.S. Department of Health and Human Services, Office of the Inspector General will perform a separate audit to determine the allowability of the pension costs claimed in accordance with the FAR, Title 48, Chapter 1, Part 21.205-6(j) and Cost Accounting Standards 412 and 413. Indirect cost rates used by NHIC are subject to audit by the Defense Contract Audit Agency (DCAA) and any changes to the rates used and those finally approved by DCAA could result in further adjustments to the FACP costs as claimed. Pension and indirect costs claimed by NHIC during each of the periods under audit were as follows:

Fiscal Year Ended:	Pension Costs	Indirect Costs	Total
September 30, 1996	\$ 6,292	69,005	75,297
September 30, 1997	286,841	1,869,120	2,155,961
September 30, 1998	588,688	4,578,702	5,167,390
Total	\$ 881,821	6,516,827	7,398,648

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Objectives and Scope of Audit. (Continued)

To meet the above stated objectives, our audit included a study of those internal control procedures of NHIC to the extent we considered necessary to evaluate the system and determine specific compliance therewith. In addition, we performed tests of specific costs to determine that NHIC complied with contractual and administrative requirements. All significant items noted during our audit are discussed in the Findings and Recommendations section of this report. Our Independent Auditors' Report on Medicare Final Administrative Cost Proposals and our Report on Compliance and On Internal Control Over Financial Reporting Based on an Audit of Final Administrative Cost Proposals Performed in Accordance with *Government Auditing Standards* are included in the Auditors' Reports section of this report.

During our audit we used judgmental sampling techniques for the purpose of determining the audit sample sizes. Our samples were designed to be representative and adequate for the purpose of expressing an opinion on the FACP's and included tests of wages, non-personnel costs, cost allocation policies and procedures, as well as specific tests for unallowable costs. Findings included in this report have been based solely upon our sample results.

AUDITORS' REPORTS

U.S. Department of Health and Human Services
Health Care Financing Administration

INDEPENDENT AUDITORS' REPORT ON
MEDICARE FINAL ADMINISTRATIVE COST PROPOSALS

We have audited the Final Administrative Cost Proposals (FACP's) (Schedule A) of the National Heritage Insurance Company (NHIC) for the fiscal years ended September 30, 1998, 1997 and 1996. The amounts reported in the FACP's are the responsibility of NHIC's management. Our responsibility is to express an opinion on the FACP's based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the FACP's are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts claimed on the FACP's. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the FACP's. We believe that our audit provides a reasonable basis for our opinion.

The accompanying schedules were prepared in accordance with the instructions of the U.S. Department of Health and Human Services and reflect only administrative costs reported for the operating of the Medicare, Part B program. Accordingly, the accompanying schedules are not intended to present financial position or results of operations in conformity with generally accepted accounting principles.

In our opinion, subject to results of U.S. Department of Health and Human Services, Office of the Inspector General and Defense Contract Audit Agency (DCAA) audits regarding the allowability of \$7,398,648 of pension and indirect costs claimed and included in the FACP's submitted by NHIC, the FACP's present fairly the costs of allowable program administration for the fiscal years ended September 30, 1998, 1997 and 1996 in accordance with the Federal Acquisition Regulation, Title 488, Chapter 1, Part 31, as interpreted and modified by the Medicare agreements.

This report is intended solely for the information and use of the NHIC, U.S. Department of Health and Human Services, Office of Inspector General, and Health Care Financing Administration and is not intended to be and should not be used by anyone other than these specified parties.

Conrad And Associates, L.L.P.

June 24, 1999

U.S Department of Health and Human Services
Health Care Financing Administration

**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER
FINANCIAL REPORTING BASED ON AN AUDIT OF FINAL ADMINISTRATIVE
COST PROPOSALS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

We have audited the Final Administrative Cost Proposals (FACP's) (Schedule A) of the National Heritage Insurance Company (NHIC) for the fiscal years ended September 30, 1998, 1997 and 1996 and have issued our report thereon dated June 24, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the NHIC's Final Administrative Cost Proposals are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of FACP amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the NHIC's internal controls over reporting of FACP's in order to determine our auditing procedures for the purpose of expressing our opinion on the FACP's and not to provide assurance on the internal control over FACP reporting. Our consideration of the internal control over FACP reporting would not necessarily disclose all matters in the internal control over FACP reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the FACP's being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over FACP reporting and its operation that we consider to be material weaknesses.

U.S. Department of Health and Human Services
Health Care Financing Administration
Page Two

This report is intended solely for the information and use of the NHIC, U.S. Department of Health and Human Services, Office of Inspector General, and the Health Care Financing Administration and is not intended to be and should not be used by anyone other than these specified parties.

Conrad and Associates, L.L.P.

June 24, 1999

FINDINGS AND RECOMMENDATIONS

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations

General and Administrative Costs Allocated to Subcontracts

During our review of indirect general and administration (G&A) costs, we noted that the Medicare contract was allocated costs based on the Total Cost Input Method. Under this methodology, the **total direct costs** of National Heritage Insurance Company (NHIC), including subcontract costs, are used as the allocation base for the G&A expense pool. FAR 9904.410-50 (d) (2) **warns** that including subcontract costs **could** significantly distort the allocation of the G&A expense pool in relation to the benefits received.

The following subcontract costs were included in the G&A Base element used to develop the G&A rates which allocate annual indirect G&A cost of the EDS Health Care SBU to the NHIC Medicare Program. The subcontract costs represent EDS Subcontract costs applicable to the NHIC Medicare Part B Prime contract. Please note that these costs represent calendar year data, for rate calculation purposes and not fiscal year data.

- Calendar Year 1996 \$ 118,600
- Calendar Year 1997 \$ 5,064,142
- Calendar Year 1998 \$11,279,541

NHIC included the following subcontract costs as part of the **total** NHIC Medicare program costs used to apply the G&A rates. These subcontract costs were reported as actual contract costs on their FACPs for the respective years.

- Fiscal Year 1996 \$ 221,346
- Fiscal Year 1997 \$12,818,138
- Fiscal Year 1998 \$17,525,440

Total G&A expenses claimed by NHIC for the fiscal years ended September 30, 1996, 1997 and 1998 were \$69,005, \$1,869,120 and \$4,578,702 respectively for a total claimed G&A expense of \$6,516,827. The total cost base used to calculate the G&A expense **included** the EDS Subcontract costs for those respective years.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations, (Continued)

For comparison purposes, we have calculated the total G&A expenses which we believe would have been charged to Medicare, using a base that **excludes subcontract costs** from the G&A calculation (the Value Added Method). The result of that calculation provides G&A expense for the fiscal years ended September 30, 1996, 1997 and 1998 as \$34,907, \$1,297,214 and \$3,514,268 respectively for a total G&A expense under the Value Added Method of \$4,846,389.

As a result of NHIC's decision to use the Total Cost Input Method rather than the Value-Added Method to allocate G&A expense pool costs, we believe that an additional \$1,670,438 of G&A costs were charged to Medicare for the three years ended September 30, 1998. Accordingly, Medicare, under the Total Cost Input Method, may have been allocated a disproportionate share of G&A costs in relation to the benefits received.

Recommendation

We recommend HCFA consider requiring NHIC to utilize the Value Added method, which **excludes** subcontract costs, rather than the Total Cost Input Method, which **includes** subcontract costs, when developing the G&A rate used to allocate indirect G&A costs of the EDS Health Care SBU to the NHIC Medicare program. In addition, we further recommend that HCFA consider requiring NHIC to exclude subcontract costs from the base when applying the G&A rate to the NHIC program. Use of the Value Added Method, we believe, would prevent a distorted allocation of G&A costs to the Medicare program in relation to the benefits received.

NHIC Response

NHIC strongly disagrees with the recommendation to use a Value Added base for allocating G&A costs. Under the Value Added method, materials and subcontracts (EDS Subcontract costs) would be excluded from the G&A allocation base. NHIC uses a Total Cost Input base (which includes all costs except G&A costs) rather than a Value Added base. In our case, subcontract costs are included in the G&A base (Total Cost Input) because *NHIC exercises significant oversight relative to the activities and services provided under the EDS Subcontract*. Unlike contracts that do not require close supervision and participation on the part of the prime contractor, such as drop shipments; NHIC does exercise close supervision and participation in order to meet HCFA standards and expectations. We have provided below examples of the level of oversight that is exercised by NHIC over the subcontract services.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations, (Continued)

- NHIC has approval authority over EDS relative to system changes, special projects, etc. – EDS does not act on the contract without authorization from NHIC. There is a defined process that is in place around projects and securing the necessary approvals – both operationally and financially from NHIC – before a project is undertaken.
- NHIC Leadership team works closely with EDS to resolve various incident reporting issues relative to system down time and any technical shortfalls in service for the purpose of assessing liquidated damages. NOTE: For FY 1999, NHIC assessed EDS nearly \$150k in liquidated damages – which reduced costs to our customer. This clearly demonstrates our oversight relative to the services provided by EDS.
- An NHIC leader has sole responsibility for working directly with the EDS subcontract leader to oversee actual credits for liquidated damages and resolve billing/service disputes/incidents between NHIC and EDS.
- The NHIC claims leadership team reviews the claims volume reports prepared by EDS, which are calculated from the EDS MCS claims processing system. The reports are reviewed for accuracy and validity.
- NHIC Sr. Leadership team (managers and directors) meet on a monthly basis to review the invoices from EDS that detail what services were provided to NHIC as well as the price NHIC was paid for those services, to ensure contract compliance.
- NHIC Finance team provides a cursory review of the invoices before the costs actually hit our books to ensure rates used in the invoices are in compliance with contract rates.

The level of oversight and management exercised by NHIC over the EDS Subcontract clearly justify inclusion of the subcontract costs in NHIC's G&A base. NHIC exercises similar oversight on direct labor costs, travel and other contract costs. This oversight further supports the use of the Total Cost Input Base, which includes total costs representing total activity. We do not believe that Medicare has received a disproportionate share of G&A in relation to the benefits received as a result of NHIC using the Total Cost Input Base for G&A allocation.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations, (Continued)

It should also be noted that the NHIC Medicare Part B contract is **not** a CAS-covered contract (with the exception of references to CAS 412 & 413) **nor** are there any references to compliance with CAS 410, which governs how G&A is to be allocated to cost objectives. Nonetheless, NHIC's use of Total Cost Input as our G&A base is consistent with the requirements of CAS 410.

CAS 410 (Allocation of business unit general and administrative expenses to final cost objectives) provides the standards with which business unit G&A expenses are allocated to final cost objectives. There are several aspects of this standard that are applicable to NHIC and our development and allocation of G&A costs. Some key excerpts from CAS 410 and the Federal Acquisition Regulation (FAR) are detailed below:

- *CAS 9904.410-40 (b)(1) Fundamental Requirements.* The G&A expense pool of a business unit for a cost accounting period shall be allocated to final cost objectives of that cost accounting period by means of a cost input base **representing the total activity of the business unit...** The cost input base selected shall be the one which best represents the total activity of a typical cost accounting period.
- *CAS 9904-410-50 (d) – Techniques for Application.* The cost input base used to allocate the G&A expense pool shall include all significant elements of that cost input which represent the total activity of the business unit... The determination of which cost input base best represents the total activity of a business unit must be judged on the basis of the **circumstances of each business unit.**
- *CAS 9904-410-50 (d)(1) –* A total cost input base is **generally acceptable** as an appropriate measure of the total activity of a business unit.
- *FAR 31-203(d)* references that the contractor's method of allocating indirect costs shall be in accordance with standards promulgated by the CAS Board, **if applicable to the contract;** otherwise, the method shall be in accordance with **generally accepted accounting principles** which are consistently applied.

Based on the foregoing, our use of the Total Cost Input base to allocate G&A costs is justified (given the total activity of the business unit) and consistent with the requirements of CAS 410.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations, (Continued)

Auditor Comment

The auditor concedes the fact that the Medicare contract is not a CAS covered contract. However, we continue to believe that HCFA should consider requiring NHIC to use the "Value Added Method" for the allocation of Home Office G&A and ROI costs given the significant amount of subcontract costs claimed by NHIC relative to the total Medicare Program costs claimed. We again emphasize FAR 9904.410-50(d)(2), which warns that the inclusion of subcontract costs in the allocation base could significantly distort the allocation of G&A expenses to various programs in relation to the benefits received.

Return on Investment Costs Allocated to Subcontracts

During our review of Return and Investment (ROI) costs, we noted that the Medicare contract was allocated ROI costs using the same method as was used to allocate G&A costs – the Total Cost Input method. In order to be consistent with the FAR section 9904.410-50 (d)(2), which states, "...inclusion of material subcontract costs would significantly distort the allocation of the G&A expense pool in relation to the benefits received..." we believe that NHC should use the Value Added Method for both G&A and ROI cost allocation purposes.

Total ROI expenses claimed by NHIC for the fiscal years ended September 30, 1996, 1997 and 1998 were \$17,137, \$392,840 and \$887,740 respectively for a total claimed ROI of \$1,297,717. The total cost based used to calculate the ROI expense included the EDS Subcontract costs for those respective years.

For comparison purposes, we have calculated the total ROI expenses, which we believe, would have been charged to Medicare using a base that excludes the subcontract costs from the rate calculation (the Value Added Method). The result of that calculation provides ROI expense for the fiscal years ended September 30, 1996, 1997 and 1998 as \$115, \$12,543 and \$27,399 respectively for a total ROI expense under the Value Added method of \$40,057.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Findings and Recommendations, (Continued)

As a result of NHIC's decision to use the Total Cost Input Method rather than the Value Added Method, we believe that an additional \$1,257,660 of ROI costs may have been charged to Medicare for the three years ended September 30, 1998. Accordingly, Medicare, under the Total Cost Input Method, may have been allocated a disproportionate share of ROI costs in relation to the benefit received.

Recommendation

We recommend that HCFA consider requiring NHIC to exclude subcontract costs from the total direct NHIC expenses used to apply the ROI rate to the NHIC Medicare program. The consistency of the Value Added Method's principles would prevent a distorted allocation of both ROI and G&A costs in relation to the benefits received.

NHIC Response

The application of a G&A rate as well as a ROI rate should be applied consistently to the same base, whichever is selected as the most appropriate base for allocation – Total Cost Input or Value Added. As is the case with the G&A application, we believe that the Total Cost Input method should be used for the ROI calculation as well and do not agree with the recommendation that a Value Added method should be used. Please refer to the citations, references and justifications under the G&A Findings and Recommendations section above that clearly support our use of the Total Cost Input base.

Auditor Comment

The auditor concedes the fact that the Medicare contract is not a CAS covered contract. However, we continue to believe that HCFA should consider requiring NHIC to use the "Value Added Method" for the allocation of Home Office G&A and ROI costs given the significant amount of subcontract costs claimed by NHIC relative to the total Medicare Program costs claimed. We again emphasize FAR 9904.410-50(d)(2), which warns that the inclusion of subcontract costs in the allocation base could significantly distort the allocation of G&A expenses to various programs in relation to the benefits received.

OTHER MATTERS

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Other Matters

1. Resolution of Prior Audit Findings

This audit covered NHIC's initial Medicare contract period with HCFA. Accordingly, no prior audit findings were reviewed.

2. Interim Expenditure Reports

As part of our audit, we performed a limited review of NHIC's Interim Expenditure Reports. Our review was limited to a review of methods and procedures followed by NHIC in developing expenditures reports.

Our tests disclosed that the methods and procedures used to report Medicare administrative costs on the Interim Expenditure Reports were adequate.

3. Data Processing Costs

NHIC did not incur any significant costs for planning, development or modification of the Medicare claims processing system during the audit period.

4. Complementary Insurance Credits

As part of our audit, we performed tests on the reported complementary insurance credits and ascertained that adequate procedures were being followed to ensure compliance with the Medicare contract.

5. Subsequent Events

On December 17, 1999, NHIC notified HCFA that the corporate G&A rates that had been billed to HCFA during the audit period contain an error relative to the calculations of the Home Office Allocations from its EDS corporate offices. Once the revised rates are finalized, NHIC will retroactively determine the financial impact to all years under their contract and work with HCFA regarding the proper accounting and treatment of the over-claimed costs.

NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1995 through September 30, 1998

Other Matters, (continued)

On January 7, 2000, NHIC notified HCFA of material weaknesses regarding indirect Return on Investment (ROI) costs. NHIC determined that the corporate ROI rates that have been billed to HCFA contain an error in the determination of assets, which are used as a basis for calculation and subsequent billing to HCFA. Once the revised rates are finalized, NHIC will retroactively determine the financial impact to all years under their contract.

Preliminary estimates prepared by NHIC indicated that the Medicare program may have been overcharged approximately \$577,000 in G&A costs and \$2,040,000 ROI costs during fiscal years 1996 through 2000.

SCHEDULES

**NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA**

Schedule of Final Administrative Cost Proposals by Cost Classification

<u>Category</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>	<u>Total</u>
Salaries and wages	\$ 22,001,901	9,907,158	281,343	32,190,402
Fringe benefits	6,600,760	3,568,893	30,242	10,199,895
Facilities or occupancy	2,446,963	1,302,056	212,902	3,961,921
Electronic data processing equipment	415,225	125,173	173	540,571
Subcontracts	17,525,350	12,818,139	221,346	30,564,835
Outside professional services	190,180	187,557	2,704	380,441
Telephone and telegraph	1,235,155	536,291	10,402	1,781,848
Postage and express	6,926,295	879,487	44,756	7,850,538
Furniture and equipment (Not EDP)	1,441,137	1,046,337	129,842	2,617,316
Materials and supplies	1,499,513	531,467	22,825	2,053,805
Travel	372,042	351,648	164,281	887,971
Return on investment	887,740	392,840	17,137	1,297,717
Miscellaneous	471,632	1,144,043	39,738	1,655,413
Credits	(8,149,400)	(3,468,954)	-	(11,618,354)
Forward funding	<u>3,370,195</u>	<u>-</u>	<u>-</u>	<u>3,370,195</u>
Totals	<u>\$ 57,234,688</u>	<u>29,322,135</u>	<u>1,177,691</u>	<u>87,734,514</u>

**NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA**

Final Administrative Cost Proposal

For the Period October 1, 1997 through September 30, 1998

<u>Operation</u>	<u>Budget Authorization</u>	<u>Administrative Costs Claimed</u>	<u>Variance- Favorable (Unfavorable)</u>
Bills/Claims Payment	\$ 32,392,900	33,190,053	(797,153)
Appeals/Reviews	5,944,200	6,088,532	(144,332)
Inquiries	7,336,000	7,215,632	120,368
Professional Education & Training	1,158,500	1,226,802	(68,302)
Participating Physician	2,565,200	951,048	1,614,152
Productivity Investment	3,710,300	3,702,287	8,013
PM Special Projects	27,300	-	27,300
Credits	<u>(8,647,100)</u>	<u>(8,149,400)</u>	<u>(497,700)</u>
Subtotal - program management	<u>44,487,300</u>	<u>44,224,954</u>	<u>262,346</u>
Medical Review	5,596,600	5,347,948	248,652
Medicare Secondary Payer	3,920,200	3,903,400	16,800
Benefits Integrity	3,066,500	3,074,684	(8,184)
Provider Education and Training	607,000	644,248	(37,248)
MIP Special Projects	<u>63,100</u>	<u>39,454</u>	<u>23,646</u>
Subtotal - medicare integrity	<u>13,253,400</u>	<u>13,009,734</u>	<u>243,666</u>
Totals	<u>\$ 57,740,700</u>	<u>57,234,688</u>	<u>506,012</u>

**NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA**

Final Administrative Cost Proposal

For the Period October 1, 1996 through September 30, 1997

<u>Operation</u>	<u>Budget Authorization</u>	<u>Administrative Costs Claimed</u>	<u>Variance- Favorable (Unfavorable)</u>
Claims Payment	\$ 17,046,600	18,364,883	(1,318,283)
Reviews & Hearings	3,051,400	2,572,916	478,484
Inquiries	<u>3,584,200</u>	<u>2,874,451</u>	<u>709,749</u>
Subtotal	<u>23,682,200</u>	<u>23,812,250</u>	<u>(130,050)</u>
Provider Education & Training	525,900	434,853	91,047
Medical Review & Utility Review	1,958,000	2,035,618	(77,618)
Medicare Secondary	1,709,000	1,746,305	(37,305)
Participating Physician	1,314,000	1,050,727	263,273
Productivity Investments	1,801,600	1,873,544	(71,944)
Credits/Other	(3,491,700)	(3,468,954)	(22,746)
Benefit Integrity	1,336,400	1,109,526	226,874
MIP Other	<u>797,200</u>	<u>728,266</u>	<u>68,934</u>
Totals	<u>\$ 29,632,600</u>	<u>29,322,135</u>	<u>310,465</u>

**NATIONAL HERITAGE INSURANCE COMPANY
CHICO, CALIFORNIA**

Final Administrative Cost Proposal

For the Period October-1, 1995 through September 30, 1996

<u>Operation</u>	<u>Budget Authorization</u>	<u>Administrative Costs Claimed</u>	<u>Variance- Favorable (Unfavorable)</u>
Productivity Investments	\$ <u>1,200,000</u>	<u>1,177,691</u>	<u>22,309</u>
Total	\$ <u>1,200,000</u>	<u>1,177,691</u>	<u>22,309</u>

APPENDIX A

AUDITEE'S RESPONSE

February 25, 2000

Mr. Ronald E. Rolwes, CPA
Engagement Partner
Conrad & Associates, L.L.P.
1100 Main St., Suite C
Irvine, CA 92614

Dear Mr. Rolwes,

The purpose of this letter is to provide you with National Heritage Insurance Company's (NHIC) response to the Findings and Recommendations section presented in your Draft Audit Report dated February 15, 2000.

Response to General & Administrative (G&A) Cost Findings and Recommendations.

NHIC strongly disagrees with the recommendation to use a Value Added base for allocating G&A costs. Under the Value Added method, materials and subcontracts (EDS Subcontract costs) would be excluded from the G&A allocation base. NHIC uses a Total Cost Input base (which includes all costs, except G&A costs) rather than a Value Added base. In our case, subcontract costs are included in the G&A base (Total Cost Input) because *NHIC exercises significant oversight relative to the activities and services provided under the EDS Subcontract*. Unlike contracts that do not require close supervision and participation on the part of the prime contractor, such as drop shipments; NHIC does exercise close supervision and participation in order to meet HCFA standards and expectations. We have provided below examples of the level of oversight that is exercised by NHIC over the subcontract services.

- NHIC has approval authority over EDS relative to system changes, special projects, etc. - EDS does not act on the contract without authorization from NHIC. There is a defined process that is in place around projects and securing the necessary approvals - both operationally and financially from NHIC - before a project is undertaken.
- NHIC Leadership team works closely with EDS to resolve various incident reporting issues relative to system down time and any technical shortfalls in service for the purpose of assessing liquidated damages. NOTE: For FY 1999, NHIC assessed EDS nearly \$150k in liquidated damages - which reduced costs to our customer. This clearly demonstrates our oversight relative to the services provided by EDS.
- An NHIC leader has sole responsibility for working directly with the EDS subcontract leader to oversee actual credits for liquidated damages and resolve billing/service disputes/incidents between NHIC and EDS.
- The NHIC claims leadership team reviews the claims volume reports prepared by EDS, which are calculated from the EDS MCS claims processing system. The reports are reviewed for accuracy and validity.
- NHIC Sr. Leadership team (managers and directors) meet on a monthly basis to review the invoices from EDS that detail what services were provided to NHIC as well as the price NHIC has paid for those services, to ensure contract compliance.

NHIC

- NHIC Finance team provides a cursory review of the invoices before the costs actually hit our books to ensure rates used in the invoices are in compliance with contract rates.

The level of oversight and management exercised by NHIC over the EDS Subcontract clearly justify inclusion of the subcontract costs in NHIC's G&A base. NHIC exercises similar oversight on direct labor costs, travel and other contract costs. This oversight further supports the use of the Total Cost Input Base, which includes total costs representing total activity. We do not believe that Medicare has received a disproportionate share of G&A in relation to the benefits received as a result of NHIC using the Total Cost Input Base for G&A allocation.

It should also be noted that the NHIC Medicare Part B contract is **not** a CAS-covered contract (with the exception of references to CAS 412 & 413) **nor** are there any references to compliance with CAS 410, which governs how G&A is to be allocated to cost objectives. Nonetheless, NHIC's use of Total Cost Input as our G&A base is consistent with the requirements of CAS 410.

CAS 410 (Allocation of business unit general and administrative expenses to final cost objectives) provides the standards with which business unit G&A expenses are allocated to final cost objectives. There are several aspects of this standard that are applicable to NHIC and our development and allocation of G&A costs. Some key excerpts from CAS 410 and the Federal Acquisition Regulation (FAR) are detailed below:

- CAS 9904.410-40 (b)(1) *Fundamental Requirements*. The G&A expense pool of a business unit for a cost accounting period shall be allocated to final cost objectives of that cost accounting period by means of a cost input base **representing the total activity of the business unit...** The cost input base selected shall be the one **which best represents the total activity of a typical cost accounting period.**
- CAS 9904-410-50 (d) - *Techniques for Application*. The cost input base used to allocate the G&A expense pool shall include all significant elements of that cost input which represent the total activity of the business unit... The determination of which cost input base best represents the total activity of a business unit must be judged on the basis of the **circumstances of each business unit.**
- CAS 9904-410-50 (d)(1) - A total cost input base is **generally acceptable** as an appropriate measure of the total activity of a business unit.
- FAR 31-203(d) references that the contractor's method of allocating indirect costs shall be in accordance with standards promulgated by the CAS Board, **if applicable to the contract;** otherwise, the method shall be in accordance with **generally accepted accounting principles** which are consistently applied.

Based on the foregoing, our use of the Total Cost Input base to allocate G&A costs is justified (given the total activity of the business unit) and consistent with the requirements of CAS 410.

Response to Return on Investment (ROI) Findings and Recommendations

The application of a G&A rate as well as a ROI rate should be applied consistently to the same base, whichever is selected as the most appropriate base for allocation - Total Cost Input or Value Added. As is the case with the G&A application, we believe that the Total Cost Input method should be used for the ROI calculation as well and do not agree with the recommendation that a Value Added method should be used. Please

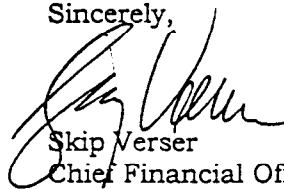
refer to the citations, references and justifications under the G&A Findings & Recommendations section above that clearly support our use of the Total Cost Input base.

Other Matters

As a follow up to the letters dated December 17, 1999 and January 7, 2000 referenced in your audit report, we have provided HCFA with additional correspondence that specifies when they can expect updated FACPs for all fiscal years impacted by the reported material weaknesses. We have attached a copy of that letter to this response.

We look forward to our responses being included in the appropriate sections of the final report as well as their entire inclusion as an attachment to the final report. If you should have any questions related to this response, please feel free to contact me at 530-896-7108.

Sincerely,



Skip Verser
Chief Financial Officer
Medicare Administrative Services

Attachment

CC: Jeff Broocks
Anne Dalton
Don Picard
Michael Quint
Toney Banks
Melinda Edge
Kim Muir

February 15, 2000

Health Care Financing Administration
Medicare Contractor Management Branch
Division of Beneficiary Services
ATTN: Alysso E. Blake, Associate Regional Administrator
75 Hawthorne Street, 5th Floor
San Francisco, CA 94105

Dear Ms. Blake,

The purpose of this letter is to provide you with an update on the progress of correcting material weaknesses identified at National Heritage Insurance Company (NHIC). As my prior letters to you noted, these weaknesses are related to the financial reporting of Administrative Costs under our Medicare Part B prime contract with HCFA.

We have been working with our corporate Government Liaison and Compliance organization to recalculate the subject rates and determine the financial impact to the contract for all years impacted. A summary of our progress on resolution of this issue is identified below:

- The General & Administrative rate has been recalculated for years 1996 through 1999 with corrected Home Office Allocations.
- The FCCOM Rate has been revised to include corrected net book value of asset information, which is used as a basis for rate calculation. The rates were revised for years 1996 through 1999.
- All fiscal year 2000 IER information that includes data from calendar year 1999 will be revised with the filing of our January IER (which will be filed February 21, 2000).
- We are scheduled to file the FY 1998 FACP by the end of February 2000. The financial information detailed in this submission will include corrected G&A and FCCOM rate information.
- We are scheduled to file the FY 1996 and 1997 FACP by March 15th, 2000 and the 1999 FACP by April 30, per MCM guidelines.
- The actual payment to HCFA for the overcharge will occur no later than March 17, 2000. Our original target for repayment was the middle of February; however, with the required FY 1998 FACP filing in February, other timing issues around FACP filings, and internal approval processes we were unable to transfer the funds at that time.

Once we have finalized our date for electronic transfers back to HCFA, I will communicate again to bring closure to this issue. If you should have any questions or concerns related to this matter, please do not hesitate to contact me at 530-896-7081.

Sincerely,


Jeff Brooks
Director, Client Delivery Executive
Medicare Administrative Services

NHIC

ATTACHMENT

CC: Anne Dalton
Don Picard
Skip Verser
Kim Muir
Melinda Edge
Jane Hite
Bill Van Blarcum
Toney Banks